

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

77-4120

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IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SIDNEY R. SOLOMON and BEATRICE SOLOMON,
Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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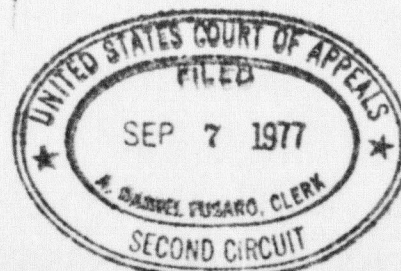


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BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court correctly determined that shares of stock received by taxpayers more than three years after the initial exchange in a non-taxable corporate reorganization pursuant to Section 354(a)(1) and Section 368(a)(1)(B) of the Internal Revenue Code of 1954 constituted payments in connection with the exchange which were subject to the imputed interest provisions of Section 483 of the Code.

STATEMENT OF THE CASE

Sidney and Beatrice Solomon (taxpayers) appeal from a decision of the Tax Court entered on March 28, 1977, that a deficiency is due from taxpayers in the amount of \$42,939.64 for their taxable year 1971. (R. 42^{1/}.) Taxpayers' petition for the redetermination of the deficiency determined against them by the Commissioner of Internal Revenue was filed in the Tax Court on February 25, 1974. (R. 1^{2/}.) On December 6, 1976, the Tax Court (Judge Goffe) filed its opinion (R. 13-27), which is reported at 67 T.C. 379^{3/}. Taxpayers timely filed a notice of appeal on June 6, 1976. (R. 3, 44.) Jurisdiction is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954.

The facts may be summarized as follows:

Taxpayers resided in New York, New York, at the time they filed their petition in the Tax Court. (R. 15.)

Prior to August 19, 1968, taxpayers, along with Samuel and Doris Katkin, owned all of the outstanding capital stock of Quinn Manufacturing Company (Quinn), a Michigan corporation. Each of the taxpayers, and each of the Katkins, owned 25 shares of Quinn stock.

1/ "R." references are to the separately bound record appendix.

2/ Taxpayers' case was consolidated for trial with the case of Katkin v. Commissioner, which is presently on appeal by those taxpayers to the Sixth Circuit. (R. 1, 13.)

3/ The court's opinion was briefly amended by order dated January 10, 1977. (R. 41.)

In addition, Sidney owned 1,391.5 shares and Beatrice owned 931.5 shares of the outstanding capital stock of Detroit Bolt and Nut Company (Detroit), a Michigan corporation. The remaining shares of Detroit were owned by the Katkins and by Quinn. (R. 15-16.)

On August 19, 1968, taxpayers entered into an Acquisition Agreement and Plan of Reorganization with Whittaker Corporation (Whittaker), a California corporation. The agreement provided for the acquisition by Whittaker of all Quinn and Detroit stock owned by taxpayers in exchange for voting stock of Whittaker. In consideration for the transfer of his shares in Quinn and Detroit, Sidney was to receive 6,037 shares of Whittaker's \$5 par value preferred stock and such number of its shares of common stock as had an aggregate fair market value of \$1,373,387, but not in excess of 22,890 shares. In exchange for the transfer of her shares in the two corporations, Beatrice was to receive 3,963 shares of Whittaker's \$5 par value preferred stock and such number of shares of its common stock as had a fair market value of \$901,613, but not in excess of 15,027 shares. On August 19, 1968, taxpayers received the designated number of preferred shares and the maximum number of common shares that could initially be received under the agreement. The shares of stock received were subject to substantial restrictions on transferability. (R. 16-17^{4/}.)

^{4/} On August 19, 1968, the Katkins also entered into an Acquisition Agreement and Plan of Reorganization with Whittaker, which provided for the exchange of all of their stock in Quinn and Detroit for voting stock of Whittaker. (R. 17-18.)

Because of the difficulty in valuing the shares exchanged between taxpayers and Whittaker, and as additional consideration to taxpayers, the agreement provided for the issuance of additional shares of Whittaker common if the value of such stock received and still retained by taxpayers on August 19, 1971, was less than 120 percent of its value on August 19, 1968, or if the value of the preferred shares received was less than \$100 per share. The agreement further provided that the maximum number of shares which might be issued be placed in a reserve account to be established by Whittaker for possible future delivery. The agreement did not provide for the payment of interest on such additional shares. (R. 17.)

On September 27, 1971, pursuant to its obligations under the agreement, Whittaker issued 29,797 additional shares of its common stock to Sidney and 19,561 shares to Beatrice. The shares were registered under the Securities Act of 1933, and had a value of \$10.125 per share. (R. 17^{5/}.)

The exchange of stock between taxpayers and Whittaker qualified as a tax-free reorganization under Section 354(a)(1) and Section 368(a)(1)(B) of the Internal Revenue Code of 1954. (R. 19.)

The Commissioner determined that interest income must be imputed to taxpayers pursuant to Section 483 of the Code upon receipt of the additional Whittaker shares in 1971, and his determination was upheld by the Tax Court. (R. 27.) From the decision based upon the determination of the Tax Court, taxpayers appeal.

5/ The Katkins' agreement similarly provided for the issuance of additional shares if the value of the Whittaker shares retained by them on August 19, 1971, was less than 120 percent of their value on August 19, 1968. Such additional shares were delivered to the Katkins on September 27, 1971. (R. 18.)

SUMMARY OF ARGUMENT

This case involves the question whether the imputed interest provisions of Section 483 of the Internal Revenue Code of 1954 apply to stock received more than three years after the initial exchange in a tax-free corporate reorganization pursuant to Sections 354 and 368 of the Code, as part of the exchange. The Tax Court determined that Section 483 applies under such circumstances. That determination is correct and should be affirmed.

Section 483 generally provides that in the case of a contract for the sale or exchange of property under which deferred payments are due more than one year from the date of such sale or exchange, and which provides for no interest, a portion of each payment received more than six months after the date of sale or exchange shall be treated as interest. The legislative history, as well as the wording of the statute, makes it clear that Section 483 governs the tax consequences "for all purposes of the Code" of "any payment" on account of "any contract for the sale or exchange of property" which is capital or depreciable in nature, where that payment is due more than one year after the date of the sale or exchange and the contract does not provide for interest. In the present case, each of the three major requirements for the imputation of interest were fulfilled, i.e., there was an "exchange" of stock for stock pursuant to the corporate reorganization provisions of the Code, there were

deferred payments more than three years after the initial exchange, and the contract made no provision for the payment of interest.

On the basis of several cases in which it has been held that contractual rights to additional shares of stock are equivalent to the stock itself for purposes of qualifying a corporate reorganization as tax-free, taxpayers contend that the Whittaker stock which they received in 1971 was not a "payment" to which Section 483 applies. It is argued that under these cases, taxpayers received nothing in 1971 which they did not already own at the time the agreement with Whittaker was executed.

This argument improperly assumes that a contractual right to equitable ownership constitutes "stock" for all purposes of the Code. There is no authority for this proposition, and it is clear that a "payment" under Section 483 refers to the actual issuance of the stock itself (along with the attendant indicia of ownership, such as voting and dividend rights, etc.), rather than a mere obligation to issue stock at some future date. Prior to such actual issuance, all that exists is a conditional promise to make a payment in the future--that is, an evidence of indebtedness--which Section 483(c)(2) specifically prohibits from being considered as a "payment."

Taxpayers additionally contend that any attempt to tax their receipt of stock in 1971 is inconsistent with the reorganization provisions of the Code, and must therefore yield to those provisions.

However, there is no conflict between the corporate reorganization provisions and Section 483.

It is clear that there is no conflict between the underlying purposes of the reorganization provisions and Section 483, since the former seek to give substance to the "continuity of investment" principle of corporate reorganizations, while the latter seeks to eliminate any possibility in deferred payment agreements for converting ordinary interest income into capital gain. Moreover, the principal and interest portions of a deferred payment are severable, and there is nothing in the reorganization provisions which requires nonrecognition of the interest portion of a deferred payment, even though such provisions require nonrecognition of any gain or loss realized with respect to the principal portion of the payment. Accordingly, since they have different purposes and apply to different portions of the deferred payments, there is no inconsistency between the reorganization provisions and Section 483.

The decision of the Tax Court should be affirmed.

ARGUMENT

THE TAX COURT CORRECTLY DETERMINED THAT THE STOCK RECEIVED BY TAXPAYERS IN 1971 WAS SUBJECT TO THE IMPUTED INTEREST PROVISIONS OF SECTION 483 OF THE INTERNAL REVENUE CODE OF 1954

A. Introduction

The single issue in this case is whether the imputed interest provisions of Section 483 of the Internal Revenue Code of 1954, Appendix, infra, apply to the receipt of stock more than three years after and supplementary to the initial exchange in a tax-free corporate reorganization pursuant to Sections 354(a)(1) and 368(a)(1) of the Code, Appendix, infra. The Tax Court ruled (R. 19-27) that Section 483 does apply in such circumstances, and, accordingly, it held that interest income must be imputed to the taxpayers upon the receipt of the additional Whittaker shares in 1971. That determination is correct and should be affirmed.

Section 483 of the Code generally provides that in the case of a contract for the sale or exchange of property under which deferred payments are due more than one year from the date of such sale or exchange, and which provides for either no interest or interest payments at a rate below that specified in the Treasury Regulations,^{6/} a portion of each payment received more than six months after the date of sale or exchange shall be treated as interest. Application

^{6/} Under Treasury Regulations on Income Tax, Section 1.482-1(d)(1)(ii), that rate is 4 percent for contracts entered into prior to July 24, 1975.

of the statute is limited to the sale or exchange of a capital or depreciable asset. Section 483(f)(3), Internal Revenue Code of 1954.

Section 483 was enacted by Congress to correct a practice whereby a seller of property on the installment basis was able to convert what would otherwise constitute interest income into capital gain by inflating the purchase price, rather than providing for interest on the deferred payments. H. Rep. No. 749, 88th Cong., 1st Sess., p. 72 (1964-1 Cum. Bull. (Part 2) 125, 196). "* * * the language which Congress used for § 483 implies that Congress intended the section to have far-reaching consequences on the Internal Revenue Code." Jeffers v. United States, 556 F. 2d 986, 993-994 (Ct. Cl., 1977). Accordingly, "the express language * * * is broad" (Cocker v. Commissioner, 68 T.C. No. 46, p. 18 (1977)), and (as noted by the Tax Court in the present case (R. 23)) it reflects Congress' intention to make the section applicable--

to any deferred payment received on the exchange of property under a contract in which no interest or inadequate interest is provided, irrespective of whether gain or loss is recognized on the exchange, except in those five instances specified in subsection (f). (Emphasis in original.)

In addition, it is clear that the part of each payment to which Section 483 applies "is to be treated as interest for all purposes of the code." H. Rep. No. 749, supra, p. A84 (1964-1 Cum. Bull. (Part 2), p. 332).

Thus, Section 483 specifically governs the tax consequences ("for all purposes of the Code") of "any payment" (Section 483(c)(1)) on account of "any contract for the sale or exchange of property" (Section 483(a)) which is capital or depreciable in nature, where that payment is due more than one year after the date of the sale or exchange and that payment does not bear interest at least in the percentage required by Regulations. (Emphasis supplied.) See Jeffers v. United States, supra, p. 993. Where these conditions exist, Section 483 applies automatically to treat a portion of the deferred payment as interest, regardless of the intentions of the parties to the transaction, and regardless of a showing that the amount paid bore a correlation to the timing of that payment. Id., p. 995. Such automatic triggering of the statutory provision is fully consistent with Congress' desire to take the "corrective action" necessary to eliminate any potential for "manipulation of the tax laws" applying to installment sales transactions. H. Rep. No. 749, supra, p. 72.

In the present case, the transaction between taxpayers and Whittaker clearly fulfilled the criteria necessary for the application of Section 483. First, there is no dispute that the transaction constituted a "sale or exchange," since the parties stipulated that the Acquisition Agreement and Plan of Reorganization executed by taxpayers and Whittaker on August 19, 1968, qualified as a non-taxable exchange of stock for stock under Section 368(a)(1)(B) of the Code. (R. 6, 7.) See Treasury Regulations on Income Tax, § 1.483-1(b)(6), Example 7, Appendix, infra.

Second, the delayed payment requirement was met, since the agreement of August 19, 1968, contained contingent provisions for payments in stock on the third anniversary of the agreement, and additional stock was actually issued to taxpayers on September 27, 1971, pursuant to the agreement.^{7/} (R. 11.)

Finally, there was an "unstated interest" element (Section 483(b)), since it was stipulated that the agreement between taxpayers and Whittaker did not provide for the payment of interest on the contingent stock obligations. (R. 12.)

The facts of this case are fully consistent with the circumstances set forth in Section 1.483-1(b)(6), Example 7, of the Treasury Regulations, which illustrates a case also involving a reorganization qualifying under Section 368(a)(1)(B) of the Code. In the example, additional shares of stock are to be received by the taxpayer provided the net profits of the acquired company exceed certain amounts specified in the contract. No interest is provided in the contract. It is concluded in the example that Section 483 of the Code applies to the transfer of the additional shares.

^{7/} Section 1.483-1(b)(1) of the Regulations, Appendix, *infra*, specifically includes stock within the meaning of the term "payments." And it is immaterial that the stock payments were contingent on the occurrence of certain events, since Section 483(d) provides that under such circumstances, the imputed interest and any resulting tax liability are to be determined as of the year in which such contingent payments were actually made.

The contingent payments in the present case differ from those made under Section 1.483-1(b)(6), Example 7, of the Regulations only to the extent that here the contingent payments were based on future stock value of the acquiring corporation, rather than on future corporate earnings. In view of the obvious lack of any substantive differences between Example 7 in the Regulations and the facts of this case, Section 483 must apply here to require the imputation of interest on the shares which taxpayers received in September 1971. See also, Rev. Rul. 70-300, 1970-1 Cum. Bull. 125, as clarified by Rev. Rul. 72-35, 1972-1 Cum. Bull. 139; Rev. Rul. 73-298, 1973-2 Cum. Bull. 173.

In view of the factors discussed above, the decision of the Tax Court was clearly correct. Taxpayers, however, advance two arguments in alleged support of their proposition that Section 483 does not apply to the facts of this case. First, it is contended (Br. 9-16) that Whittaker's issuance of additional stock to taxpayers in September of 1971 did not constitute a deferred "payment" to which Section 483 can apply. Second, taxpayers argue (Br. 16-27) that any attempt to tax their receipt of Whittaker stock in 1971 is inconsistent with the reorganization provisions of the Code and must therefore yield to those provisions. Both of these arguments lack merit.

B. Whittaker's transfer of additional stock to taxpayers in September of 1971 constituted a deferred payment within the meaning of Section 483

Taxpayers contend (Br. 9-16) that their receipt of the additional Whittaker stock in 1971 was not a deferred "payment" for purposes of Section 483, basing their argument on cases (Carlberg v. United States, 281 F. 2d 507 (C.A. 8, 1960); Hamrick v. Commissioner, 43 T.C. 21 (1964), acq., 1966-1 Cum. Bull. 2) in which a contractual right to additional shares of stock has been construed to be equivalent to the shares themselves for purposes of a qualifying corporate reorganization. It is argued that taxpayers' right to equity ownership was established with finality under the contract of 1968, and that the subsequent delivery of additional shares effected nothing more than a formal change in the indicia of stock ownership, rather than a change in the substance of such ownership.

These arguments are unsound. At the outset, it is important to note that despite taxpayers' attempts to escape the fact (Br. 7, 10), the courts in Jeffers v. United States, supra, pp. 995-996, and Catterall v. United States, 68 T.C. No. 35, pp. 10-11 (1977), carefully considered and rejected the very same arguments, and taxpayers err in asserting that (Br. 5-6) the Tax Court in this case did not seriously consider the issue. Indeed, the Tax Court granted taxpayers' motion for reconsideration of its opinion on this point, and slightly modified the opinion as a result. (R. 41.)

To be sure, the opinions in Carlberg, supra, and Hamrick, supra, stand for the proposition that contractual rights to additional shares of stock constitute "stock" within the meaning of Section 354(a)(1) of the Code, and not "other property" under Section 356(a)(1), and that the delivery of the additional shares is entitled to the same treatment under the reorganization provisions as the stock initially received. However, these decisions are not at all inconsistent with the decision in the present case, since there is absolutely no authority for the argument implicit in taxpayers' brief (p. 9) that a contractual right to equitable ownership constitutes "stock" for all purposes of the Code, or, more particularly, for purposes of Section 483.

Nor is there any correlation, as taxpayers imply, between the corporate reorganization provisions of the Code and Section 483. As stated in Section 1.1002-1(c) of the Regulations, the underlying assumption of the tax-free exchange provisions--

is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

Totally unrelated to this "continuity of investment" principle lying at the heart of the nonrecognition provisions is the purpose of Section 483, as explained by the Tax Court in Cocker v. Commissioner, supra, pp. 19-20:

While the purpose of the statute has been said to be to prevent the conversion of ordinary income into capital gain * * * its purpose is not limited to that. The broader purpose of the statute is to prevent the conversion of interest into principal. The principal portion of any payment may represent gain to the seller, but it may also represent a return of his capital investment at either no gain or a loss.

Section 483 reflects a congressional intent to tax transactions according to substance, not form. S. Rep. 830, 88th Cong., 2d Sess. (1964), 1964-1 (Part 2) C.B. 606. And in substance a portion of the deferred payments received in certain sales or exchanges represents compensation paid for the use of property during the period of deferral (i.e. interest). * * * Section 483 merely seeks to tax what in substance is income to sellers in deferred payment sales or exchanges.

In view of the authorities cited above, it is obvious that the purposes of the corporate reorganization provisions of the Code are totally different from the purposes underlying the imputed interest provisions of Section 483. Moreover, it is clear that the courts in

Carlberg and Hamrick, in treating contractual rights to additional stock as "stock" for purposes of the reorganization provisions, were merely adhering to the "continuity of investment" principle underlying those provisions since the rights thus represented could not have produced anything other than stock. Carlberg v. United States, supra, pp. 519-520; Hamrick v. Commissioner, supra, p. 33.

Clearly, the treatment of contractual rights to additional stock as "stock" under the corporate reorganization provisions does not logically carry over to the imputed interest provisions, since "continuity of investment" is not one of the underlying purposes of Section 483. On the other hand, taxpayers' inchoate rights to receive additional stock in this case did not carry with them any of the indicia of true stock ownership (e.g., voting and dividend rights (R. 26)), and therefore were not, in fact, stock.^{8/}

Clearly, it is the actual issuance of the stock itself (as opposed to an obligation to issue stock) which constitutes a "payment" for purposes of Section 483.^{9/} Compare Section 1.483-1(b)(1) of

^{8/} In view of this lack of voting and dividend rights, taxpayers' assertion (Br. 10) that their receipt of the actual stock in 1971 amounted to nothing more than a change in the "formal indicia" of taxpayers' equity ownership is obviously untrue.

^{9/} This principle is not altered by Rev. Rul. 70-120, 1970-1 Cum. Bull. 124, in which it was held that shares placed in escrow at the time of reorganization were transferred on the effective date of reorganization, and, therefore, Section 483 did not apply. Under the facts of that Ruling, the shares deposited in escrow were issued in the names of the shareholders of the transferor corporation who were, during the escrow period, entitled to vote the escrowed shares and receive all dividends paid. No such circumstances were present here. (R. 26.)

the Regulations with Section 1.483-1(b)(5) of the Regulations, Appendix, infra. And it is the deferral the actual issuance of the stock (i.e., of the "payment") which gives rise to the imputation of interest under Section 483. Prior to such issuance, all that exists is a conditional written promise to make a payment in the future--that is, an evidence of indebtedness--which Section 483(c)(2) specifically prohibits from being considered as a "payment." Jeffers v. United States, supra, p. 996; Catterall v. Commissioner, supra, p. 11.

As stated by the Court of Claims in Jeffers, supra, p. 996--

The focus of the reorganization provisions is upon what ultimately will be issued in exchange for the certificates of contingent interest, whereas the focus of the imputed interest provisions is upon when that ultimate issuance occurs. (Emphasis in original.)

This rationale is fully consistent with the purpose of Section 483 to neutralize any potential for converting ordinary income into capital gain, or, more broadly, interest into principal. Such a potential existed in the present case, where taxpayers' receipt of the additional Whittaker stock, with its attendant voting and dividend rights, was deferred for more than three years after the initial exchange. Accordingly, the Tax Court correctly determined that the imputed interest provisions of Section 483 applied.

C. There is no conflict arising from the application of both Section 483 and the corporate reorganization provisions of the Code to the transaction in this case

As their second major argument, taxpayers contend that Section 483 and the reorganization provisions cannot both apply to the contingent stock transaction in this case, because the two sets of provisions directly conflict with one another. In alleged demonstration of such conflict (Br. 18), taxpayers argue that while Section 483 "presupposes a payment due at least six months after an exchange," Section 1223(1) of the Code "provides that stock received during the course of a qualifying reorganization is considered to have been held, for all purposes under the income tax laws, from before the date of the exchange." (Emphasis in original.) In such circumstances, taxpayers argue, the specific provisions of the reorganization sections must take precedence over the general provisions of Section 483.

The basic premise underlying taxpayers' arguments in this regard is incorrect, and there is no conflict between the statutory provisions as applied to the facts of this case.

In the present case, there was a "continuity of investment," and thus the transaction qualified for nonrecognition under the reorganization provisions of the Code. In view of such qualification, the Whittaker stock received by taxpayers is indeed treated (under Code Sections 358(a)(1) and 1223(1)) as having the same basis and the same holding period as the stock originally surrendered by taxpayers. However, while this carryover treatment is necessary for the computation of whatever gain or loss

may ultimately be realized--and recognized--whenever taxpayers dispose of their Whittaker stock in a taxable transaction,^{10/} it has no relevance whatsoever to the application of Section 483. "The interest portion of these deferred payments [of Whittaker stock] is severable from the principal portion and is not a payment for the property exchanged." Cocker v. Commissioner, supra, p. 20. Because the interest portion is severable, the statutory provisions for carryover basis and holding period do not apply to such portion. Thus, since they are based upon totally different policy considerations, and apply differently to different portions of the deferred payments, there is no conflict between the reorganization provisions and Section 483.^{11/}

Taxpayers mistakenly rely upon Fox v. United States, 510 F. 2d 1330 (C.A. 3, 1975), to support their theory that the reorganization provisions may override Section 483. (Br. 19-21.) That case involved a husband's attempt to have interest imputed under Section 483 on deferred payments made by him under the terms of a settlement agreement executed in contemplation of a divorce decree, so that he could claim a deduction for

^{10/} As noted by the Court of Claims in Jeffers, supra, p. 994, the taxation of any gain realized by taxpayers as a result of the exchange of stock with Whittaker is merely deferred. The carryover basis provisions applicable to this transaction (Section 358(a)) will cause any gain realized to be subject to recognition when taxpayers dispose of their Whittaker stock in a taxable transaction.

^{11/} The cases of Bulova Watch Co. v. United States, 365 U.S. 753 (1961), and Movielab, Inc. v. United States, 494 F. 2d 693 (Ct. Cl., 1974), cited by taxpayers (Br. 18, 21), are not to the contrary.

interest paid. The Third Circuit held that Section 483 did not apply in that context.

In Fox, the husband was obligated under the agreement to pay his former wife \$1,000,000 for the relinquishment of her marital rights, with a \$300,000 initial payment and payment of the balance over 9-1/2 years in quarterly installments. The agreement did not provide for the payment of interest. Under Sections 71 and 215 of the Code, the payments were neither taxable to the wife nor deductible by the husband. The decision in Fox, that Section 483 did not apply in those circumstances, is readily distinguishable from this case.

First, the husband's settlement in Fox of his wife's claims for alimony, support, etc., was not a "sale or exchange of property," which is the only type of transaction giving rise to the application of Section 483.

If the wife in Fox had received periodic payments of alimony, or if the payments in settlement of her claims had been spread over more than 10 years, she clearly would have received and been taxable upon ordinary income, pursuant to Sections 71(a)(1) and 71(c)(2) of the Code.^{12/} Indeed, were it not for the specific provisions of Section 71(c)(1),^{13/} the amounts received by the

^{12/} Section 215 of the Code permits a deduction to the husband for amounts that are included in the wife's income under Section 71.

^{13/} Section 71(c)(1) excludes from a wife's gross income installment payments discharging a part of a husband's obligation the principal sum of which is specified in the divorce decree or agreement. Under Section 71(c)(2), however, if the terms of the decree or agreement allow the principal sum to be paid over a period ending more than 10 years from the date of the agreement, the payments are includable in the wife's income.

wife in settlement of her claims for alimony would also have been taxable to her as ordinary income, under the well established principle that payments received in settlement of a claim are to be treated for tax purposes in the same manner as the claim itself. Lyeth v. Hoey, 305 U.S. 188 (1938). As stated by the Supreme Court in Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 265 (1958): "The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income."

Thus, the wife in Fox would not have been permitted to obtain capital gains treatment of the amounts received either in fulfillment of her marital rights or in settlement thereof. The relinquishment of her inchoate marital rights was indistinguishable from the extinction of a claim by settlement, and, accordingly, was not a "sale or exchange." Fairbanks v. United States, 306 U.S. 436 (1939); Hudson v. Commissioner, 20 T.C. 734 (1953). And she disposed of no "property." Commissioner v. Gillette Motor Co., 364 U.S. 130, 134-136 (1960). Moreover, nothing in Section 71(c)(1) alters this result, or otherwise converts her alimony settlement into a "sale or exchange of property." In contrast, there was clearly an "exchange of property" in the present case, and the realized gain from that transaction, if recognized, would be long-term capital gain.

A second basis for distinguishing Fox was aptly stated by the Tax Court in Catterall v. Commissioner, supra, pp. 12-13:

Unlike sections 71 and 215 which are broadly couched in terms of the gross income of the wife, section 354 merely provides that no gain is recognized in the case of certain reorganizations described in section 368. Gain, as computed under section 1001(a), is merely one category of gross income described in section 61. Interest, the type of income with which we are concerned, is separately listed in section 61(a)(4). Although gain on the exchange of property is generally the only type of income realized in a reorganization in which no "boot" is received, the language of the reorganization sections does not specifically prohibit the recognition of other types of income. Therefore, no conflict exists between sections 483 and 354 and thus there is no basis for the application of the above-mentioned rule of statutory construction as in Fox. (Emphasis in original.)

Thus, while in effect Section 71(c)(1) specifically prohibits the wife's recognition of gross income where it applies with respect to amounts received from the husband, and Section 215 specifically precludes the husband from deducting from his gross income any such amounts not includable in the wife's gross income under Section 71(a), Code Sections 354 and 368 do not specifically prohibit the recognition of types of income other than gain, as that term is defined in Section 1001(a) of the Code. Accordingly, a separately listed item of gross income like interest is specifically encompassed by the provisions of Code Sections 71 and 215, but is not specifically precluded from recognition as income by Code Sections 354 and 368. Under these

circumstances, there is no incompatibility between the decision in Fox and the Commissioner's position here.^{14/}

It is clear that underlying all of taxpayers' conflict arguments is the notion that the reorganization provisions of the Code are exclusive with respect to any and all tax consequences relating to such transactions.^{15/} However, taxpayers cite no authority for this proposition, and it is directly contrary to the Congressional intention "that part of each payment (under a contract for the sale or exchange of property) to which section 483 applies is to be treated as interest for all purposes of the code." H. Rep. No. 749, supra, p. A84 (1964-1 Cum. Bull. (Part 2), p. 332).

During the years in issue, Section 483(f)(3) provided:^{16/}

(3) Treatment of seller.--In the case of the seller, the tax treatment of any amounts received on account of the sale or exchange of property shall be made without regard to this section if no part of any gain on such sale or exchange would be considered as gain from the sale or exchange of a capital asset or property described in section 1231.

^{14/} For the same reason, and for the reason that the wife's relinquishment of her marital rights did not constitute a "sale or exchange of property," the Commissioner's position in the present case is not inconsistent with the conclusion in Rev. Rul. 76-146, 1976-1 Cum. Bull. 144, where it was held that the provisions of Section 483 do not apply to installment payments made to a former spouse under a divorce agreement that are not includable in the former spouse's gross income under Section 71.

^{15/} For example, taxpayers assert (Br. 27) that "the courts should not alter the tax-free nature of a qualifying reorganization." (Emphasis in original.)

^{16/} The Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1520, Section 1901(b)(3)(B), changed the wording of the exception for years beginning after December 31, 1976; however, as noted by the Tax Court in Cocker v. Commissioner, supra, p. 24, the change was made to conform to the additions of Sections 64 and 65 to the Code and was not intended to cause any substantive change in the law.

In defining the scope of this exception, the legislative history gives considerable insight not only into the situations excepted from the application of Section 483, but the situations included within the application of Section 483 as well. That history states (H. Rep. No. 749, supra, p. A87 (1964-1 Cum. Bull. (Part 2), p. 335):

Paragraph (3) of section 483(f) excepts, in the case of the seller, amounts received on account of the sale or exchange of property from the tax treatment provided under section 483, if no part of any gain on such sale or exchange would be considered as gain from the sale or exchange of a capital asset or property described in section 1231 of the code. The determination of whether this exception applies is made without regard to whether, in fact, the sale or exchange results in a gain or whether the gain (if any) would be recognized, or whether section 1245 or section 1250 of the code applies to some or all of the gain (if any). (Emphasis supplied.) 17/

Thus, Congress clearly intended Section 483 to apply to a sale or exchange of property without regard to the recognition of gain or loss, as long as gain (had there been any) would have been "considered" as gain from capital or depreciable property. In other words, Congress intended not to provide an exception for transactions in which gain was unrecognized, unless, hypothetically considered, all gain would have been ordinary in nature. 18/

In view of these circumstances, Section 1.483-1(b)(6), Example 7, of the Regulations (which, as we have previously demonstrated, is directly applicable to this case) represents a

17/ Section 1.483-2(b)(3) of the Regulations, Appendix, infra, closely parallels the above-quoted legislative history.

18/ Taxpayers' argument (Br. 23-24) that Section 483 cannot take "precedence" over the reorganization provisions without specific statutory language to that effect, is totally without merit. The legislative history quoted above makes it clear that Congress did not intend the nonrecognition exchanges to be excepted from the operation of Section 483. See Catterall v. Commissioner, supra, p. 14.

reasonable and consistent interpretation of Section 483, and, as such, is valid. Commissioner v. South Texas Co., 333 U.S. 496, 501 (1948). Accordingly, the Tax Court correctly determined that Section 483 applies to deferred payments received in an otherwise tax-free corporate reorganization.

CONCLUSION

For the foregoing reasons, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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SEPTEMBER, 1977.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 6th day of September, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) General Rule.--

(1) In General.--No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

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SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) Reorganization.--

(1) [as amended by Sec. 218(a), Revenue Act of 1964, P.L. 88-272, 78 Stat. 19] In General.--For purposes of parts I and II and this part, the term "reorganization" means--

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(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

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SEC. 483 [as added by Sec. 224(a), Revenue Act of 1964,
supra]. INTEREST ON CERTAIN DEFERRED PAYMENTS.

(a) Amount Constituting Interest.--For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) Total Unstated Interest.--For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of--

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of a payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary or his delegate. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not

more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment.

(c) Payments to Which Section Applies.--

(1) In general.--Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract--

(A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and

(B) under which, using a rate provided by regulations prescribed by the Secretary or his delegate for purposes of this subparagraph, there is total unstated interest.

Any rate prescribed for determining whether there is total unstated interest for purposes of subparagraph (B) shall be at least one percentage point lower than the rate prescribed for purposes of subsection (b)(2).

(2) Treatment of evidence of indebtedness.--For purposes of this section, an evidence of indebtedness of the purchaser given in consideration for the sale or exchange of property shall not be considered a payment, and any payment due under such evidence of indebtedness shall be treated as due under the contract for the sale or exchange.

(d) Payments That Are Indefinite as to Time, Liability, or Amount.--In the case of a contract for the sale or exchange of property under which

the liability for, or the amount or due date of, any portion of a payment cannot be determined at the time of the sale or exchange, this section shall be separately applied to such portion as if it (and any amount of interest attributable to such portion) were the only payments due under the contract; and such determinations of liability, amount, and due date shall be made at the time payment of such portion is made.

(e) Change in Terms of Contract.--If the liability for, or the amount or due date of, any payment (including interest) under a contract for the sale or exchange of property is changed, the "total unstated interest" under the contract shall be recomputed and allocated (with adjustment for prior interest (including unstated interest) payments) under regulations prescribed by the Secretary or his delegate.

(f) Exceptions and Limitations.--

(1) Sales price of \$3,000 or less.--This section shall not apply to any payment on account of the sale or exchange of property if it can be determined at the time of such sale or exchange that the sales price cannot exceed \$3,000.

(2) Carrying charges.--In the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property shall be made without regard to this section if any such amounts are treated under section 163(b) as if they included interest.

(3) Treatment of seller.--In the case of the seller, the tax treatment of any amounts received on account of the sale or exchange of property shall be made without regard to this section if no part of any gain on such sale or exchange would be considered as gain from the sale or exchange of a capital asset or property described in section 1231.

(4) Sales or exchanges of patents.--

This section shall not apply to any payments made pursuant to a transfer described in section 1235(a) (relating to sale or exchange of patents).

(5) Annuities.--This section shall not

apply to any amount the liability for which depends in whole or in part on the life expectancy of one or more individuals and which constitutes an amount received as an annuity to which section 72 applies.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.483-1 Computation of interest on certain deferred payments.

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(b) Payments to which section 483 applies--(1) In general.

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For purposes of the preceding sentence, the term "sales price" does not include any interest payments provided for in the contract. The term "sale or exchange" includes any transaction treated as a sale or exchange for purposes of the Code. For purposes of section 483, a payment may be made in cash, stock or securities, or other property (except as provided in subparagraph (5) of this paragraph).

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(5) Evidence of indebtedness. For purposes of section 483, an evidence of indebtedness (whether or not negotiable and whether or not includible in gross income) of the purchaser given in consideration for the sale or exchange of property is not a payment, and any payment due under such evidence of indebtedness shall be treated as due under the contract for the sale or exchange.

(6) Examples. The provisions of this paragraph may be illustrated by the following examples:

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Example (7). M Corporation and N Corporation each owns one-half of the stock of O Corporation. On December 31, 1963, pursuant to a reorganization qualifying under section 368(a)(1)(B), M contracts to acquire the one-half interest held by N for an initial distribution on such date of 30,000 shares of M voting stock, and a nonassignable right to receive up to 10,000 additional shares of M's voting stock during the next 3 years, provided the net profits of O Corporation exceed certain amounts specified in the contract. No interest is provided for in the contract. No additional shares are received in 1964 or in 1965, but in 1966 the annual earnings of O Corporation exceed the specified amount and on December 31, 1966, an additional 3,000 M voting shares are transferred to N. Section 483 applies to the transfer of the 3,000 M voting shares to N on December 31, 1966. See example (2) of paragraph (e)(3) of this section for an illustration of the computation of total unstated interest in this case.

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(e) Payments that are indefinite as to time, liability, or amount--(1) In general. In the case of a contract for the sale or exchange of property under which there are any indefinite payments, section 483 shall be separately applied to each such indefinite payment as if it (and any amount of interest attributable to such indefinite payment) was the only payment due under the contract, and the effect of the application of section 483 shall be determined at the time such payment is made. For purposes of section 483, a payment shall be considered as indefinite if the liability for, or the amount or due date of, such payment cannot be determined at the time of the sale or exchange. Thus, if, at the time of the sale or exchange, some or all of the payments under the contract are indefinite, the determination as to whether there is total unstated interest (see paragraph (d) of this

section), and if so, the computation of the amount of total stated interest which is includible in or deductible from income (see paragraph (c) of this section), shall be made separately with respect to each indefinite payment as of the time it is received, taking into account the time interval between the sale or exchange and the receipt of the payment (to the nearest 6-month interval). Section 483 shall be applied separately to the aggregate of any definite payments which may also be due under the contract. Section 483 does not apply to any indefinite payment which is made no more than 1 year after the date of the sale or exchange even if there are other payments (definite or indefinite) under the contract made more than a year after such date. The provisions of this subparagraph shall apply notwithstanding the fact that the obligation under which such payment is made has been valued and the transaction treated as "closed" for purposes of determining gain or loss. See paragraph (b)(5) of this section for rules relating to evidence of indebtedness. See paragraph (b)(1)(i) of § 1.483-2 for rule relating to the effect on indefinite payments of the exception for contracts with a sales price of \$3,000 or less.

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(3) Examples. The provisions of this paragraph may be illustrated by the following examples:

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Example (2). M Corporation and N Corporation each own one-half of the stock of O Corporation. On December 31, 1963, pursuant to a reorganization qualifying under section 368 (a)(1)(B), M contracts to acquire the one-half interest held by N for an initial distribution on such date of 30,000 shares of M voting stock, and a non-assignable right to receive up to 10,000 additional shares of M's voting stock during

the next 3 years, provided the net profits of O Corporation exceed certain amounts specified in the contract. No interest is provided for in the contract. No additional shares are received in 1964 or in 1965, but in 1966 the annual earnings of O Corporation exceed the specified amount and on December 31, 1966, an additional 3,000 M voting shares are transferred to N. The fair market value of such shares on the date of transfer is \$60,000 (\$20 per share). The total unstated interest applicable to the indefinite payment is \$8,262, computed as follows:

Indefinite payment to which sec. 483 applies.....	\$60,000.00
Less: Present value of such pay- ment (\$60,000 x 0.86230 (fac- tor for 33 to 39 months, col. (b), Table I)).....	<u>51,738.00</u>
Total unstated interest.....	8,262.00

See paragraph (a)(2) of § 1.483-2 for the effect on a reorganization defined in section 368(a)(1) of treating a portion of voting stock as interest under section 483.

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§ 1.483-2 Treatment as interest for purposes of Code; exceptions and limitations to application of section 483.

(a) Treatment as interest for purposes of Code--* * *

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(2) Other effects of treating portion of sales price as unstated interest. * * *. The treatment of any portion of voting stock as interest under section 483 will not prevent an otherwise eligible acquisition from qualifying

as a reorganization under section 368(a)(1) (relating to definitions of corporate reorganizations), although the payment of cash or property other than voting stock will prevent certain acquisitions from so qualifying. * * *

(b) Exceptions and limitations to the application of section 483-- * * *

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(3) Capital asset or section 1231 property--
(i) Treatment of seller. In the case of the seller, the determination of the tax treatment of any amounts received on account of the sale or exchange of property shall be made without regard to section 483 if no part of any gain on such sale or exchange would (if the property were sold at a gain) be considered as gain from the sale or exchange of a capital asset or property described in section 1231 (relating to property used in the trade or business and involuntary conversions). The determination of whether the exception of the preceding sentence applies shall be made without regard to whether any gain or loss is realized on the sale or exchange, whether any realized gain or loss would be recognized, or whether some other provision of law, such as section 1245 (relating to gain from dispositions of certain depreciable property) or section 1250 (relating to gain from dispositions of certain depreciable realty) applies, or would apply, to some or all of the gain. For example, the provisions of section 483 apply to deferred payments of stock or securities by a corporation which is a party to a reorganization, notwithstanding that under section 354(a) no gain or loss is recognized on the transaction. Similarly, the provisions of section 483 apply to deferred payments made to a corporation for its stock, notwithstanding the non-recognition of gain or loss to the corporation under section 1032 (relating to exchange of stock for property).

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